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Tax Treaty Policy Framework and Country Model

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Tax Treaty Policy Framework and Country Model

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1. Introduction

All countries would find it beneficial to develop a tax treaty policy framework and a model treaty before entering into negotiations. You have to 'know what you want'.

The policy framework should set out the main policy outcomes that your country wishes to achieve under its tax treaties. It should identify:

- policy outcomes that are most beneficial to your country;
- outcomes that must be achieved in any negotiation; and
- how much flexibility negotiators have on other issues, including what is their 'bottom line' (i.e. the minimum outcome that must be achieved).

The model treaty should reflect the country's key policy and drafting preferences, having regard to international treaty norms and to domestic law.

This paper seeks to provide guidance to developing countries on how to develop a tax treaty policy framework and their own model tax treaty.

2. Policy framework for developing countries

2.1 General

i. As far as practicable, countries should follow the international norms for tax treaties, with respect to structure and policy positions.

For developing countries, these international norms are mainly set out in the United Nations Model Double Taxation Convention between Developed and Developing Countries ("UN Model Convention"). The Organisation for Economic Co-operation and Development's Model Tax Convention on Income and on Capital ("OECD Model Convention") is also important and, for some countries, a regional model such as the Andean Community Model, the Southern African

Development Community (SADAC) Model or the Association of Southeast Asian Nations (ASEAN) Model[1] may also be relevant.

ii. It is important for developing countries to strike the right balance between protecting revenue (by maintaining source taxing rights) and encouraging inbound investment (by reducing tax barriers). To achieve this, tax treaties of most developing countries generally follow the UN Model Convention, rather than the OECD Model Convention.

   – The UN Model Convention is better suited to developing countries in that it seeks to preserve a higher level of source taxation than the OECD Model Convention, which has been designed by and for developed countries. While the OECD Model Convention is most beneficial to business, and therefore is most effective in attracting foreign investment, the revenue balance is generally best suited to capital exporting countries, and to situations where the balance of investment between the two treaty partner countries is approximately equal. The UN Model Convention modifies the OECD Model Convention to better suit the circumstances of developing countries.

iii. The policy framework of a country should take account of key aspects of that country's economy, including its main sources of revenue and areas of current or potential foreign investment.

   – If, for example, a developing country has significant natural resources such as oil reserves, it may wish to ensure that its tax treaties do not unduly restrict its ability to tax the income from activities relating to the exploitation of such resources. Similarly, if there are significant road or rail transport activities between two neighbouring countries, those countries may wish to extend the operation of Article 8 to those forms of transport.

iv. Tax treaty policy should take account of domestic law. The interaction between domestic law and treaties is important.

   – Treaties generally have priority over domestic law so that, to the extent that the treaty is inconsistent with domestic law, the treaty will prevail. It is unrealistic to expect that treaties will be wholly consistent with domestic law, but nevertheless domestic law may be a relevant consideration in designing tax treaty policies and models. In particular, countries should consider whether and how a taxing right allocated in a treaty would be exercised

[1] Intra-ASEAN Model Double Tax Convention on Income, 1987

under domestic law. For example, a treaty right to tax fees for technical services on a net basis at source may be difficult to apply in practice if such fees are taxed on a withholding basis under domestic law. In this case, the country may prefer to include a provision that provides for source taxation on a gross basis, even if the tax rate provided under the treaty is lower than the domestic law rate.

- A right to tax under a treaty that cannot be exercised under domestic law, or that cannot be collected in the ordinary course of tax administration is likely to be of little value to a country. For example, there would be little revenue benefit to be gained by providing for source taxation of pensions (in accordance with Article 18(2) (Alternative B) of the UN Model Convention), if such pensions are not taxable under domestic law. There may however be circumstances in which a country would wish to preserve a taxing right that cannot currently be exercised under existing domestic law, e.g. where it is anticipated that future governments may wish to change that domestic law.
- In some circumstances, non-tax laws may be relevant. For example, social security pensions may not be payable to non-residents. If this is the case, that country will not pay cross-border social security payments and negotiators should not insist on source taxation of these payments.

v. Countries should take into account the ability of their tax administrations to comply with treaty obligations.

- For example, some treaties require tax administrations to collect taxes on behalf of a treaty partner. If the tax administration does not have the legal or practical ability to do so, that country may wish to consider not including the article, or amending it, or delaying its implementation.

2.2 International norms

- Coverage

Tax treaties apply to individuals and entities that are residents of one or both of the treaty partner countries. Generally, residential status will be determined by the domestic law of each country. However, for treaty purposes, the UN Model Convention (like the OECD Model Convention) specifies that the person must be 'liable to tax' in the country by reason of particular criteria.

Treaties apply to all income taxes, including capital gains taxes, taxes on profits, withholding taxes and tax on salaries. In some circumstances, other taxes such as tonnage taxes, or minimum taxes may also be covered.

The UN and OECD Model Conventions also apply to taxes on capital, such as wealth taxes.

- Distributive rules

One of the main effects of a tax treaty is to allocate taxing rights over different categories of income derived by a resident of one treaty partner from sources in the other treaty partner country.

The distributive rules of the UN Model Convention broadly allocate source country taxing rights as follows:

- *Income from immovable property*: Income such as rents, agricultural or forestry profits, and mining income is seen as having a very strong economic link with the country in which it arises. Accordingly, the source country is allocated unlimited taxing rights over this income.
- *Business profits*: Such profits are generally only subject to source taxation where the foreign enterprise has established a strong economic connection with the source country, e.g. by establishing a fixed place of business in that country or by performing services in that country for an extended period. Profits from short-term activities (generally less than 6 months), or preparatory or auxiliary activities may not be taxed in the source country.

  Treaties include rules that determine the profits attributable to the enterprise, or the part of an enterprise, operating in the source country. Under the UN Model Convention, as under the OECD Model Convention, profit allocation between a permanent establishment and the rest of the enterprise of which it is a part, and between related enterprises, must be made on an arm's length basis (i.e. as if they were separate and independent entities). However, the UN Model Convention provides limits on the extent to which dealings between parts of an enterprise will be recognised. Article 7 of the OECD Model Convention, on the other hand, was amended in 2010 to give full effect to the arm's length principle.
- *International transport*: Taxation of profits from international air and sea transport is generally not permitted in the source state. However, for income from certain shipping operations in the source country, one of the two alternative provisions in the UN Model Convention provides for limited source taxation. Source taxation is not provided for under the OECD Model Convention.

- *Dividends, interest and royalties*: This income is usually taxed on a withholding basis in the source country. To prevent excessive taxation and to achieve a sharing of revenue from such income between the two countries, source taxation is limited to a percentage of the gross amount of the income. In most treaties entered into by developing countries, the agreed rates are commonly between 10 and 20%. The OECD Model Convention specifies withholding tax rates of 5 and 15% for dividends and 10% for interest, while royalties may not be taxed at source.
- *Capital gains*: Gains on disposal of immovable property or assets of a permanent establishment may be taxed in the source country, as may some gains on the alienation of shares in resident companies or companies whose assets consist mainly of immovable property. Source taxation of most other capital gains is generally not permitted. The OECD Model Convention does not provide for source taxation of gains from the alienation of shares in resident companies.
- *Independent personal services*: Income from professional services and other independent personal services is permitted in the source country only if the services are performed through a fixed base in the source country, or if they are provided in the source country for more than 183 days. Such income is dealt with as business profits under the OECD Model Convention.
- *Employment income*: Source taxation is generally permitted for employment activities performed in that country. However, an exemption is provided for certain short-term employment activities undertaken in a country on behalf of a foreign employer.

  Directors' fees: Remuneration paid to directors and other top-level managers of a local company may be taxed in the country of which the company is a resident. Under the OECD Model Convention, remuneration of top-level managers is treated in the same way as other employment income.

- *Entertainers*: Income of entertainers and sportsmen may be taxed in the country where the entertainer or sportsman performs those activities.

  Pensions: For pensions paid in respect of past employment, 2 alternatives are found in the UN Model Convention, i.e. 1) taxation only in the country of which the recipient is a resident, or 2) source taxation if the pension is paid by a resident or permanent establishment. Pensions paid under the social security system of a country may be taxed at

source. Under the OECD Model Convention, pensions are taxable only in the country of residence.

- Government service: Salaries paid to government employees are generally taxable only in the paying country.
- Students: Taxation of payments from abroad for the education and maintenance of a visiting student is not permitted.
- *Other income*: Income that is not otherwise specifically covered by the above articles may be taxed in a country if it arises in that country. The OECD Model Convention provides for taxation only in the country of residence.

  Capital: The allocation of taxing rights over capital generally mirrors the allocation of rights to tax income.

- Elimination of double taxation

Where source taxation is permitted under the tax treaty, the country of which the taxpayer is a resident is required to relieve any resulting double taxation. This may be achieved by exempting the income that is taxed at source (exemption method), or by providing a credit for the foreign tax against the tax liability of the taxpayer in the country of residence (credit method).

Though not included in the UN Model Convention itself, some treaties entered into by developing countries include tax sparing provisions. Developing countries may seek to attract foreign investment by offering tax incentives with respect to certain activities. However, if the country of residence of the investor provides relief using the credit method, the benefit of the tax incentives may be effectively passed to the foreign treasury instead of the investor. To preserve the benefit of the source country tax incentives, tax sparing provisions provide relief from taxation in the country of residence as if tax had been paid in the source country.

- Non-discrimination

International tax treaty rules prevent either country from applying discriminatory tax rules in certain circumstances. These are:

- nationals of the other country may not be taxed more harshly than the country's own nationals;
- tax discrimination against Stateless persons is not permitted;

- a permanent establishment of an enterprise resident in the treaty partner cannot be taxed less favourably than a local enterprise;
- payments to a resident of the other country must be deductible under the same conditions as if paid to a local resident;
- foreign-owned resident companies cannot be taxed more harshly than locally-owned resident companies.

- Mutual Agreement Procedure

A key benefit of tax treaties is that they allow the tax administrations to consult together on the application and interpretation of the treaty and to reach agreement on how best to achieve the aims of the treaty, especially removal of double taxation. The mutual agreement procedure is most commonly invoked in the context of transfer pricing and profit allocation. The two tax authorities may agree on the allocation of profits within a multinational enterprise operating in both countries.

In the case of disputes as to the proper attribution of such profits, taxpayers themselves may seek agreement between the tax authorities of the two countries under the Mutual Agreement Procedure.

A recent addition to the UN and OECD Model Conventions is a provision for binding arbitration in treaties (e.g. paragraph 5 of the Mutual Agreement Procedure article of the UN Model Convention).

- Exchange of Information

A tax treaty authorises and requires tax administrations to exchange relevant tax information, including information held by financial institutions. This is a very powerful tool in preventing fiscal evasion by taxpayers.

Some countries may seek to include an article in their treaties that provides for reciprocal assistance between the two tax administrations in collecting outstanding tax liabilities.

2.3 Designing a policy framework

A developing country's tax treaty policy framework should take into account international norms. At a minimum, the treaty should cover elimination of double taxation on income, non-discrimination, mutual agreement procedure and exchange of tax information. The OECD Model Convention and UN Model Convention provisions on these aspects of a tax treaty should be accepted as representative of the international standard by any country if it wishes to enter into tax treaties,

although there may be room for negotiation with respect to certain details (which are discussed further below).

Other aspects of a tax treaty may be open to negotiation, such as coverage of capital taxes, and levels of source taxation permitted under the treaty. Departures from the international models will almost always increase the difficulty of negotiating a satisfactory treaty. Accordingly, countries, especially those with limited negotiating capacity, should deviate from the international norms only sparingly, i.e. where there is a clear national interest in doing so. On these aspects, each country should determine:

a. its preferred position;
b. the priority the country places on achieving that position; and
c. the degree of flexibility available to negotiators and any fixed 'bottom line'.

2.4 Distributive rules

The allocation of taxing rights between the source and residence countries is generally the most controversial part of tax treaty negotiations. The distributive rules of a treaty, which are set out in the UN Model Convention in Articles 6 to 22, determine how the taxing rights will be allocated with respect to different categories of income. In developing its tax treaty policy framework, it is important that each country decide its preferred position on the balance of source and residence taxation, the priority it gives to maintaining that preferred position and, where flexibility is appropriate, the bottom line for negotiators.

A developing economy with minimal outbound investment may feel that it should protect its revenue by retaining the maximum possible source taxation. However, this must be balanced against the primary objective for entering into tax treaties, e.g. to make the country a more attractive destination for foreign investment by removing or reducing tax barriers to inbound investment.

Tax treaties inevitably involve some reductions in source taxation. Under the international Models, the reductions generally occur where:

- source taxation may result in excessive taxation that cannot be relieved by the country of residence (e.g. where high rates of withholding tax are likely to result in source tax that exceeds the tax on profit in the residence country);

- the economic link between the derivation of the income and the country where it arises is not strong, e.g. casual or temporary business operations or employment activities; or
- the compliance burden on taxpayers is very high or the administratively difficult or inefficient, e.g. international transport.

The distributive rules in the UN Model Convention are generally the starting point for developing countries, often with the addition of a provision that allows source taxation of fees for technical services. Regional models reflect rules that are acceptable between countries within that region, which may be different to those that would be acceptable in treaties with other countries. For example, the ASEAN Model is indicative of the reductions in source taxation that are likely to be found in a tax treaty between countries in the South East Asian region. Much more significant reductions in source taxation may be required in a tax treaty between an ASEAN member and another country.

In negotiations with developing countries, even countries that follow the OECD Model Convention will usually (though not always) agree to allow source taxation to the extent provided in the UN Model Convention. It must be kept in mind, however, that deviations from the UN Model Convention or, where relevant, a regional Model, to provide for increased source taxing rights over a particular category of income will almost inevitably be achieved only by making concessions on other aspects of the treaty, e.g. a lower rate or a higher threshold for source taxation with respect to another category of income. It is therefore extremely important for a country that wishes to provide for additional source taxing rights, over and above those found in the UN Model Convention or its regional Model, to decide how much priority should be given to achieving that outcome. For example, if it is a high priority for a country to provide for source taxing rights over fees for technical services in its treaties, then that country may be requested to forgo source taxation over other categories of income in order to achieve this result.

With respect to each category of income, developing countries may find it helpful to analyse the distributive rules of the UN Model Convention – and the OECD Model Convention – in the context of their own circumstances. In particular, they may wish to consider:

1) *Category of income*

   Does the treaty classification of income give rise to difficulties in applying the treaty, or to unacceptable policy outcomes?

Example 1: A payment is treated under domestic law as a royalty to which withholding tax applies. If that payment is regarded as business profits rather than a royalty as defined for tax treaty purposes, payers and recipients of the payments, as well as tax administrations, may find it difficult to apply the rules of Article 7 in respect of that payment.

Example 2: Fees for technical services are often treated under domestic law in developing countries as a separate category of income from other business profits and are subject to different tax treatment. Article 7, if applied to such income, may give rise to outcomes that, from a policy perspective, are unacceptable to those countries.

2) Tax treatment

Can taxing rights allocated under a tax treaty be exercised in your country? If not, consider whether this is an outcome that your country wishes to provide for under a treaty.

Example: Article 16 of the UN Model Convention provides for taxation of directors' fees in the country in which the company is a resident. Some countries may not be able to exercise this taxing right unless the director's activities are performed in that country.

Is the proposed source taxation treatment consistent with the method of taxation of that category of income under domestic law, e.g. net taxation by assessment, withholding, etc?

Example: Article 7 of the UN Model Convention provides for net taxation of business profits. However, certain payments that are classified for treaty purposes as business profits (e.g. fees for technical services) are taxed on a withholding basis under the domestic law of some countries. Such countries may wish to consider whether to adopt a different approach under their treaties.

3) Ease of administration

Does the proposed treatment present any particular difficulties for the tax administration of your country? Such difficulties may include issues relating to administrative burden, especially where tax liability is determined by assessment by tax authorities (rather than self-assessment or withholding), or relating to interpretation or application of treaty provisions.

Example: Difficulties can arise where an undefined term used in the UN Model Convention (e.g. 'paid' in Article 11) is interpreted in the Commentary in the way that is contrary to the established meaning of the same term for purposes of domestic law.

Is relevant information that is necessary for the administration of the provision readily obtainable?

Example: Article 8 (alternative B) of the UN Model Convention allows a country to tax 'an appropriate allocation of the overall net profits' of a non-resident shipping enterprise. Determination of such profits may be difficult, particularly if non-resident shipping enterprises are taxed under the domestic law of that country on a deemed profit calculated by reference to the fares or freight received by the enterprise in that country.

4) *Ease of compliance*

Does the proposed treatment place an onerous compliance burden on taxpayers? This can be a particular problem where taxpayers are required to keep detailed records that they would not ordinarily keep, or meet strict information disclosure requirements in order to obtain treaty benefits.

Example: Many countries choose to simplify compliance by taxpayers by not including the 'force of attraction' provisions of the UN Model Convention in Article 7(1). Others may consider that the provisions of Article 5(3)(b) of the UN Model Convention relating to the existence of a deemed services permanent establishment create an undue compliance burden on taxpayers.

Countries are well advised to follow the provisions of the UN or OECD Model Conventions as closely as possible for the reasons outlined above. However, having regard to their particular circumstances, countries may determine that the UN or OECD Model Conventions do not fully meet their needs, or that certain provisions of one or other of these Models cause them unacceptable difficulties. By developing a policy framework, these countries will be able to decide in advance what rules will best serve their country's interests, and how important those rules are to that country.

In deciding to move away from a policy position endorsed in the UN Model Convention, or the OECD Model Convention, countries should, in relation to each policy issue, consider the matters raised above. In addition, they should consider:

1) *Reason*

What is the reason for the departure from the policy position found in the international models? For example, is the proposed approach intended to protect a significant source of revenue in your country, e.g. income from natural resources, manufacturing profits, fees for technical services, etc?

Is the departure intended to attract investment in an area of your country's economy that your government is seeking to develop, e.g. building technical expertise, financial services, etc?

Is the usual approach found in the international models too difficult for the tax administration or taxpayers to administer in the context of your domestic law?

2) *Priority*

How much of a priority is it for your country that this outcome be achieved, vis-à-vis other issues? Is this an outcome that must be achieved, or something that is highly desirable but not essential, or is achieving this outcome not of particular importance to your country?

As far as possible, departures from the international norms should only sought for important issues. If a policy outcome is preferred, but not important, countries with limited negotiating skills and experience may be better off focussing on those resources on achieving key outcomes.

3) *Achievability*

Is this treatment likely to be readily accepted by the treaty partner country? Is it consistent with regional norms? Have other countries sought or accepted this approach in their treaties?

4) *Flexibility*

Is your government prepared to allow negotiators any flexibility on this issue? Is this a deal-breaker? Is there scope for compromise, e.g. different time threshold, different rate limit, exclusion/inclusion of certain provisions?

5) *Fall-back positions*

If there is scope for compromise, what fall-back positions would be acceptable to your government? What is the bottom line?

Finally, countries should be forward-looking in designing their policy framework and Model. Treaties usually last for many years – often decades. Renegotiation of a treaty is time-consuming and expensive, so it is worthwhile to consider policies that are robust and sustainable in the long term, and that have regard to likely developments within the country and in the international tax context.

Policy concerns that are commonly encountered by developing countries, and the issues that they raise for designing a model tax treaty, are discussed in more detail below.

3. Designing a Model Tax Treaty

Countries should develop a model tax treaty (Model) that reflects the key aspects of their policy framework. For ease of negotiation, and to maximise the likelihood of designing effective provisions that achieve the desired outcomes, developing countries would be well-advised to base their Models as far as practicable on the UN Model Convention.

Certain features of the UN and OECD Model Conventions are found in virtually all modern tax treaties, i.e:

- provision for elimination of double taxation;
- inclusion of non-discrimination rules;
- provision for mutual agreement between tax administrations; and
- most importantly, provision for exchange of tax information between tax administrations, including information held by banks and other financial institutions.

It is highly recommended that any country's Model should include these fundamental provisions. In addition, most treaties adopt the basic structure of the UN and OECD Model Conventions, i.e:

I. Scope of the Convention (Articles 1 and 2)
II. Definitions (Articles 3 to 5)
III. Taxation of Income (Articles 6 to 21)
IV. Taxation of Capital (Article 22)
V. Methods for the Elimination of Double Taxation (Article 23)
VI. Special Provisions (Articles 24 to 28)
VII. Final Provisions (Articles 29 to 30)

In designing a Model, developing countries are strongly advised to use not only the structure and principles but also the text of the UN or OECD Model Conventions wherever possible. Although the meaning of the text of the Models may not always be abundantly clear, especially where the language of the UN or OECD Model Convention is not the first language of the reader, the terms of those Models are found in thousands of tax treaties and are interpreted in accordance with the Commentaries and/or in jurisprudence around the world.

Developing countries would be well-advised to avoid making minor drafting changes, notwithstanding that those changes might better align the text of their treaties to terms used in their

local language or in their domestic law. Deviations from the text of the UN or OECD Model Conventions may well be taken to signal that the negotiators intended to achieve a different outcome to that provided under the Models. By adopting the text used in the relevant Model, countries are able to demonstrate their intention to achieve the outcomes provided in that Model as interpreted in the Commentaries. As far as possible, drafting changes should only be used where a different result is sought.

In cases where, in accordance with their policy framework, countries want to achieve a different outcome to that provided in the UN Model Convention, different provisions will need to be used. In these circumstances, if no suitable text can be found in the OECD Model Convention or in the Commentary to either the UN Model Convention or the OECD Model Convention, it is advisable to search for examples of provisions used in other treaties to achieve the same or a similar outcome. These may be found in regional Models or on the OECD Tax Treaty Website for Tax Officials[2]. The OECD website sets out many alternative provisions from existing treaties and is an extremely valuable free resource for treaty negotiators. If no suitable precedent is available, drafting of a new provision in a country's Model should seek to follow the style and text of the UN and OECD Model Conventions as closely as possible.

Countries should regularly review their Model to ensure that it remains up to date in the light of international developments and changes in the country's circumstances. In particular, changes to the UN or OECD Model Conventions should be considered and, where appropriate, incorporated into a country's model tax treaty.

Issues commonly encountered by developing countries in designing their Model

3.1 Taxes covered

Capital taxes

While both the UN and OECD Model Conventions cover capital taxes, some treaties do not. The decision whether to include capital taxes in a tax treaty depends on whether such taxes are imposed in both treaty partner countries. If both countries impose capital taxes, then double taxation can arise where capital belonging to a resident of one country is taxed by the other country. In these

[2] Tax officials from all countries may register with the OECD Centre for Tax Policy and Administration Secretariat .

circumstances, provisions to eliminate such double taxation should be included in any treaty between the two countries.

However, not all countries impose capital taxes under their domestic law. In designing their Model, countries that do not themselves impose capital taxes will need to consider whether they wish to cover capital taxes.

Double taxation of capital will not arise if one of the treaty partner countries does not impose capital taxes, or if neither does. In this case, it is a policy decision whether a country that does not impose capital taxes would want to include a Capital Taxes article in its treaties. Such an article may encourage outbound investment by residents of that country by limiting the circumstances in which the other country could impose tax on the capital of residents of the first country. However, this may not be seen as particularly desirable by developing countries that want their residents to keep their capital at home.

Coverage of capital taxes would ensure that, if a country subsequently introduces such taxes, any double taxation arising in respect of those taxes would be relieved. However, the imposition of such taxes in the future would be limited in accordance with the treaty provisions.

Taxing rights over capital taxes are generally allocated in accordance with Article 22 of the UN or OECD Model Conventions. These provisions allow taxation of capital represented by immovable property situated in a country, or movable property of a permanent establishment (or a fixed base, under the UN Model Convention) situated in that country. Capital represented by ships and aircraft used in international traffic may only be taxed in the country where the place of effective management is situated. Under the OECD Model Convention, all other elements of capital are taxable only in the country of residence. The UN Model Convention leaves the question open to negotiations.

If a developing country that does not currently impose capital taxes decides to include this Article, and is concerned about limitations on future policy options with respect to capital taxes, one option may be to provide, in respect of capital that is not otherwise specifically dealt with under the article, for taxation in the country where the capital is situated. This would ensure that, if in the future that country introduces capital taxes, the treaty would not limit their application (other than with respect to capital represented by ships and aircraft used in international traffic).

Some treaties provide, for example, that all other capital may be taxed in both countries. If double taxation arises as a result, the country of residence of the taxpayer would be required to provide relief. An alternative approach is to provide for taxation only in the country where the capital is located. However, this is likely to be more difficult to negotiate since few countries are prepared to give up taxing rights over their own residents.

3.2 Distributive rules

Treaties provide for different methods of source taxation and for certain minimum thresholds for taxation of income derived by non-residents. The method and threshold depends on the category of income derived.

Business activities

Treaties generally provide an exemption from source taxation for income derived from temporary or preliminary business activities of non-resident enterprises. The aim of these provisions is to reduce the tax compliance burden of such enterprises unless they have a substantial participation in the economy of the host country. The relevant thresholds for source taxation are as follows:

Fixed place of business

Business profits of a non-resident will be taxable in the source country only if the non-resident enterprise has a permanent establishment (PE) in that country and the profits are attributable to that PE. A PE is primarily defined as a fixed place of business through which the enterprise conducts its business. A place of business will generally be regarded as 'fixed' if that place is at the disposal of the non-resident enterprise for at least 6 months.

This threshold for source taxation is widely accepted by both developing and developed countries for most non-service business activities, e.g. manufacture, hotels, mining, retail, etc. For service activities, the UN Model Convention includes an additional time threshold (see below).

Countries with significant natural resources, especially off-shore resources such as gas or petroleum reserves, may consider that a lower threshold is appropriate. These countries often include special provisions in the definition of "permanent establishment" (such as provisions to deem substantial equipment or natural resource activities to be a PE) or include an Offshore Activities Article which provides a shorter time threshold in respect of such activities.

Some treaties also provide an exception to the fixed place of business threshold in respect of insurance activities. For example, countries that impose tax on the basis of gross premiums paid to non-resident insurers under domestic law may preserve the operation of this law under tax treaties, sometimes with the rate of tax being capped to a certain percentage (e.g. 5% or 10%) of the gross amount of the premiums.

Construction sites

While the OECD Model Convention provides for a 12-month threshold for construction and assembly projects, a 6 month threshold is provided under the UN Model Convention and is widely accepted internationally. Some developing countries seek a shorter time threshold in their treaties, e.g. 90 days.

In designing a Model, the time threshold should not be less than any domestic time threshold for taxation of such activities. Doing so could lead to double non-taxation of income of non-resident construction or assembly enterprises in treaties with countries that apply an exemption system (ie. where income that may be taxed in the host State under the treaty is exempted from tax in the other State). This is because, while the treaty accords the host State the right to tax the income, that State would not be able to exercise that right if the construction site lasts less than the domestic law time threshold.

Services

Income from services is commonly dealt with under a number of different articles of a tax treaty. Under the UN Model Convention, services are deemed to constitute a PE (and therefore be taxable under Article 7 unless dealt with under another specific article) where:

- Supervisory activities in connection with a building site or assembly project etc are carried on in the State for more than 6 months; or
- Services are performed in a State for the same or connected project for more than 6 months.

These additional threshold provisions, though not part of the OECD Model Convention, are widely accepted in treaties with developing countries.

Another threshold that is not found in either the OECD Model Convention or UN Model Convention, but is found in a few treaties, deems a PE to exist where substantial equipment is used in a State. This additional threshold is particularly relevant to countries with off-shore natural

resources, since large mobile equipment such as oil rigs may not meet the criteria for being a fixed place of business. As noted above, a lower time threshold is provided where the equipment is used for natural resource activities. The substantial equipment provision may also be relevant to domestic transport operations.

Specific types of services are dealt with under the following provisions. Where these provisions apply, they will have priority over the general rules provided in respect of services income in Article 7.

Profit Attribution

Treaties seek to avoid the double taxation that can arise as a result of differing attribution by the two countries of profits to a permanent establishment under Article 7 *Business Profits*, or to a related enterprise under Article 9 *Associated Enterprises.* While the arm's length standard is common to virtually all tax treaties, countries need to decide the extent to which dealings between different parts of an enterprise should be taken into account. In this regard Article 7 of the UN Model Convention differs from the OECD Model Convention in that it generally disallows deductions for amount 'paid' by a permanent establishment to another part of the enterprise such as the head office[3]. Countries that wish to adopt the more limited approach to profit attribution should be careful to follow the wording of the UN Model Convention Article 7.

The UN Model Convention also provides for limited 'force of attraction', which allows the source country to tax, in addition to profits attributable to a permanent establishment, profits arising in that country from sales of the same or similar goods, or the provision of the same or similar services. Although this approach is not commonly found, even in treaties of developing countries, those countries that wish to provide for such force of attraction should include in their Model the additional wording found in the UN Model Convention.

International traffic (Article 8)

Article 8 of the UN and OECD Model Conventions deal with income from international transport separately from other business profits, primarily because the usual rules for taxation of business profits would be difficult to apply in the context of international transport operations since airlines and shipping operators would be likely to have a PE in many countries. Furthermore, the calculation

[3] See discussion in paragraphs 1 – 3 of the Commentary on Article 7 of the UN Model Convention.

of the profits attributable to each PE is very difficult, since much of the income derives from activities carried out on or above international waters.

International treaty practice is to provide for profits from international transport by air, or by boat in inland waterways transport, to be taxed only in the country where the place of management of the enterprise is situated. The OECD Model Convention Article 8 and UN Model Convention Article 8 (alternative A) provide for similar treatment of profits from international shipping. UN Model Convention Article 8 (alternative B) provides a different approach which allows the source country to tax a percentage of the overall net profits from the shipping operations if such operations in that State are more than casual.

Another approach found in some treaties is to allow the source country to tax income from international shipping in accordance with domestic law, but to reduce the tax payable by 50 percent. This allows those countries that apply source taxation on a gross basis to the freight payable on goods or passengers shipped in that country to continue to do so, albeit at a reduced rate of taxation.

Developing countries will need to decide which approach they should adopt for international shipping, having regard to their policy preferences, administrative capacity and their domestic law. They may also want to consider whether profits from international road and rail transport should be dealt with under this Article, or in accordance with the usual rules of Article 7 for business profits.

Income from independent personal services (Article 14)

Under the UN Model Convention, income derived by a resident from professional services or other independent activities would be taxable in the country in which the services are performed if:

i. the non-resident service provider has a fixed base in that country through which the services are provided; or
ii. the service provider is present in that country for more than 183 days.

The OECD Model Convention no longer includes a specific article dealing with independent personal services. Such income is dealt with under Article 7, which requires that the income be attributable to a PE of the non-resident service provider.

Although the majority of countries take the view that Article 14 applies only to personal services provided by individuals, the use of the term ‘resident’ leaves the scope of the article open to

interpretation. For this reason, some countries like to clarify that this article applies only to individuals, while others extend its scope to activities performed by entities such as companies.

Since Article 14 refers to 'income', countries that tax independent personal services incomes on a gross basis under their domestic law are not precluded from doing so under this article. However, as the majority of countries apply Article 14 to net income, countries that wish to apply gross basis taxation should clarify this during negotiations.[4]

Some treaties include a third threshold which allows a country to tax income from independent personal services where income exceeding a monetary threshold is paid by a resident of that country or a PE situated in that country. Such a threshold was previously found in the UN Model Convention but was deleted in 1999. Countries considering whether to include such a provision should note that monetary thresholds are difficult to administer and the amount becomes meaningless over time.

Independent personal services income may also be dealt with under provisions dealing with fees for technical services (see below). Where a treaty includes technical services provisions, the relationship between the two articles should be clarified, e.g. by excluding such fees from the scope of Article 14.

Fees for technical services

Under their domestic law, many developing countries collect withholding tax on fees for technical services paid by one of their residents or borne by a PE situated in their country. The application of the usual tax rules for business profits provided under Article 7 may present an administrative problem for fees that are taxed on a withholding basis under domestic law, since there may be no mechanism for reporting this income or allowing deductions against it. Accordingly, these countries often wish to include a provision in their treaties that allows them to continue to apply their withholding taxes.

Provisions to allow withholding on fees for technical services generally extend similar treatment to such fees as is provided in respect of royalties. This is achieved either by including fees for technical services in the definition of 'royalties' in Article 12, or by including a separate article dealing specifically with such fees and drafted along similar lines to the royalties article of the UN Model Convention. A limit (generally around 10 - 15 percent of the gross amount of the fees) is imposed on source taxation.

[4] See paragraphs 10 and 11 of the Commentary on Article 14 of the UN Model Convention.

Although such a provision is not currently included in either the OECD Model Convention or the UN Model Convention, it can be found in a significant number of treaties of developing countries. The UN Committee of Experts on International Cooperation in Tax Matters ("The UN Committee of Experts") is currently considering whether to add a provision to the UN Model Convention to deal with fees for technical services.

Since this provision is not consistent with current international treaty norms (which would require a PE or fixed base threshold, or at least a minimum time threshold), it may be resisted, particularly by countries that follow the OECD Model Convention. If it is a high priority for a developing country to include this provision in its treaties, it must be recognised that some treaty partner countries are likely to insist on concessions on other articles of the treaty, e.g. reductions on withholding taxes or other reductions in source taxation.

For this reason, it would be prudent for any country that includes a provision for technical services fees to have fall-back positions. For example, inclusion of the article may be strongly resisted by some treaty partners because it does not include a requirement that the income be from services performed in that State. Including a requirement that the services be performed in the State would also be consistent with taxation of services income under Article 5/7 and under the Independent Personal Services article. Consideration could also be given to including a minimum time or monetary threshold, at least as a fall-back position.

Income from technical services that is effectively connected with a PE is excluded from the scope of this article, and will fall under Article 7 pursuant to which only the *profits* from such services may be taxed in the source country. This may encourage non-resident service providers to establish a PE in order to obtain the benefit of net taxation (which may result in less tax imposed at source).

The relationship between the fees for technical services provision and Article 14 dealing with income from independent personal services should be clarified. It may be expected that the technical services provision, being more specific, would have priority over Article 14. Nevertheless, it would be useful to put this beyond doubt by, for example, excluding fees for technical services from the scope of Article 14.

Countries that include a provision dealing with fees for technical services should ensure that the meaning of 'technical services' (or other term used) is clear. Some countries define these services as services of a 'technical, managerial or consultancy nature', while others consider that all services

involving a technical element are covered, while yet others will only apply the provision to services connected to a transfer of technology.

Entertainment (Article 17)

In international tax treaty practice, unlimited source taxation of income derived by artistes and sportsmen from their entertainment activities is permitted. Taxation on a gross basis is not precluded under this article, but countries should consider whether they wish to include in their Model, or would be prepared to agree in negotiations to, provision for:

- net taxation only;
- a minimum monetary threshold; and/or
- an exemption from source taxation for remuneration of entertainers who participate in a cultural exchange funded by Government.

Professors and Teachers

Although neither the OECD Model Convention nor the UN Model Convention includes a separate provision dealing with income derived by visiting teachers or professors, a limited exemption is often found in treaties of developing countries that wish to attract the services of foreign educators.

The Commentary on Article 20 of the UN Model Convention includes a discussion on issues that should be considered in preparing a provision dealing with remuneration of teachers and professors, including:

- the possibility of creating double exemption (e.g. if the teacher ceases to be a resident for tax purposes in the other country);
- the inclusion of a time limit (normally 2 years) and the application of that limit;
- the possibility of limiting the exemption to teaching services performed at 'recognised' institutions or research performed in the public (v. private) interest;
- whether an individual should be entitled to benefits under the article in respect of more than one visit.

Since these provisions are often difficult to administer and the same benefit could be achieved with more precision through domestic law, consideration should be given to whether any benefit or exemption for such remuneration should be provided under domestic law.

Withholding taxes on dividends, interest and royalties

Dividends and Branch Profits Tax

Most countries impose withholding tax on some or all dividends paid by a resident company to its foreign shareholders. Treaties generally provide that the country of residence of the paying company may tax dividends paid to a resident of the other country, but if that person is the beneficial owner of the dividends, the rate of tax is limited to a certain percentage of the gross amount of dividends.

Treaty withholding tax rate limits on dividends often differentiate between non-portfolio inter-corporate dividends (i.e. where the shareholder is a company that owns a significant holding in the paying company) and other dividends. The UN Model Convention Article 10 does not specify percentage rates, but the OECD Model Convention Article 10 provides a rate limit of 5% for non-portfolio inter-corporate dividends, and 15% for all other dividends. There are however many different approaches and rate limits found in existing treaties, ranging from a single rate for all dividends, or split rates ranging from 0% to much higher rates.

In designing their Model, developing countries should take into account the total tax that will be imposed on corporate profit, including tax at the company level and tax imposed on successive levels of shareholders. A high level of dividend withholding tax, while it may operate to defer repatriation of profits by local companies to foreign owners, is also likely to discourage foreign investors from establishing or investing in local companies in the first place.

Most treaties provide lower rates of withholding on non-portfolio inter-corporate dividends to reduce the incidence of recurrent taxation. However, some countries may find it difficult to administer the dual rates under their domestic law and may prefer to provide in their Model a single rate applicable to all dividends.

Under their domestic law, some countries impose an additional tax on the profits of a local branch of foreign enterprises. This tax is intended to provide broad equivalence between methods of conducting business so that, regardless of whether a foreign enterprise conducts business in the source country through a branch or a subsidiary, similar levels of source tax are payable. The additional tax may take many forms, including the imposition of a higher rate of tax on branch profits of foreign enterprises, or a tax on the after-tax profits of the branch at a similar rate to dividend withholding taxes, or a tax on remittances of branches to their head office.

Neither the UN or OECD Model Conventions provide for any additional branch profits tax. However, provision for branch profits taxation in tax treaties is not uncommon, particularly in treaties of developing countries. If such a provision is included, the additional tax should be limited to the same rate as that applicable to non-portfolio inter-corporate dividends, and should apply to the after-tax amount of the branch profits, to ensure maximum consistency between taxation of profits of subsidiaries and branches.

Interest

The UN Model Convention does not provide specific figures for limits on interest withholding tax rates. However, treaties with developing countries generally limit withholding tax on interest beneficially owned by a resident of a treaty partner country to 10 or 15 percent. Some regional models such as the ASEAN Model specify 15 percent.

Developing countries should decide what rate they would consider appropriate for their Model, bearing in mind that high rates of withholding may deter investment or may result in the tax cost being passed on to resident payers through increased interest rates.

Consideration should also be given to whether, either as part of their Model or as a concession as part of the treaty negotiation process, a lower rate could be accepted in certain circumstances. Such lower rate, or exemption, could apply to all interest, or to certain categories of interest, such as those discussed in paragraphs 12 to 17 of the UN Commentary on Article 11.

In particular, consideration should be given to the withholding tax rate on interest derived by financial institutions. Given the cost of funds to financial institutions, and the narrow margins of profit obtained on funds lent by those institutions, even a low rate of withholding on the gross amount of the interest will frequently absorb (or even exceed) the whole amount of the profit on the lending activities.

Royalties

The UN Model Convention differs from the OECD Model Convention in that the former allows source taxation of royalties, while the latter provides for exclusive residence taxation. Unsurprisingly, treaties of developing countries almost invariably provide for source taxation. The UN Model Convention Article 12 does not specify a withholding rate limit on royalties that are beneficially owned by residents of the other country, but in practice limits in developing country treaties range between 10 and 25 percent. When setting the rate limit in their Model, countries are

advised to take into account the considerations set out in paragraphs 4 to 11 of the Commentary on Article 12 of the UN Model Convention.

One issue that commonly arises is the treatment of income from equipment leasing. Payments for the use of equipment are excluded from the definition of royalties in the OECD Model Convention, but remain in the UN Model Convention definition. Countries may wish to consider providing a lower rate for income from equipment leasing, either in their country Model or as a fall-back. Leasing income will have costs associated with it, and even a fairly low withholding tax rate imposed on the gross amount of the income may well result in excessive taxation which would discourage cross-border equipment leasing or may be passed on to resident lessees. A limit of about half of the general rate for royalties may be appropriate.

Capital gains

Treaties generally ensure that tax imposed on capital gains on alienation of immovable property located in a country, and movable property which is part of business property of permanent establishment or a fixed base in that country, may be taxed in that country. Capital gains arising from the disposal of ships or aircraft used in international traffic, and boats used in inland waterways transport, are generally taxable only in the country in which the place of effective management of the enterprise is situated.

For other gains, treaty practice varies. Some countries provide for exclusive residence country taxation. However others, including most developing countries, prefer to retain source country taxing rights over a broader range of capital gains, especially gains from the disposal of shares in a resident company or interests in an entity of which the assets consist mainly of immovable property.

In designing their Model provisions on capital gains, countries should consider, in particular, which gains are taxable under their domestic law, and the extent to which their tax administration is able to enforce tax liabilities of non-residents on such gains.

Pensions

While the OECD Model Convention Article 18 and the UN Model Convention Article 18 (alternative A) provide that pensions paid in consideration of past employment are generally taxable only in the country in which the recipient resides, the UN Model Convention Article 18 (alternative B) allows source taxation of such pensions if they are paid by a resident of the source country or a

permanent establishment situated in that country. The UN Model Convention also provides that pensions paid in respect of government service and social security payments are taxable only in the paying country. In practice, many countries seek source taxing rights over pensions in their treaties. Examples of different provisions are found in the OECD Commentary on Article 18.[5]

Countries should make a policy decision as to which alternative they prefer (or indeed, whether they would prefer another alternative such as a single tax treatment for all pensions). This decision should take into account, inter alia, the ability of the tax administration to collect source taxation on pensions paid to non-residents. Countries that tax pensions by withholding under domestic law, for instance, are more likely to be able to collect source tax in accordance with Article 18 (alternative B).

3.3 Relief of double taxation

- Elimination of double taxation

The UN and OECD Model Conventions require the country of residence to relieve double taxation that arises in cases where source taxation is permitted under the treaty. The residence country has the option of relieving such double taxation either by the exemption method or the credit method.

A policy decision should be made as to which of these methods is preferred in relation to the different categories of income. Most countries prefer to align the method of relief to their domestic law relief provisions. However, some countries that relieve double taxation by the credit method under domestic law may provide for exemption of certain categories of income under a tax treaty in order to simplify compliance and administration.

- Tax Sparing

Tax sparing is an arrangement under which one country will agree to provide a credit for another country's tax, notwithstanding that the tax has not actually been imposed because of tax incentives provided by that other country. The purpose of tax sparing is to ensure that the benefit of the incentive is not 'soaked-up' by the country of residence of the taxpayer.

The treaties of many developing countries include a tax-sparing provision to protect the application to residents of the treaty partner country of tax incentives.

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5 See paragraphs 12 to 21 of the Commentary on Article 18 of the OECD Model Convention.

While some countries are prepared to agree to such provisions with their least developed treaty partners, others are more resistant, especially since the OECD published a report recommending caution in agreeing to tax sparing provisions in treaties[6]. Nevertheless, this can be an important benefit to developing countries of entering into tax treaties. Developing countries that wish to seek tax sparing would be well advised to consider how important the inclusion of such provision is to them, and the extent to which they might be prepared to consider limitations such as limitations on the activities to which the tax sparing provisions would apply, or limitations on the duration for which the provisions would apply.

3.4 Non-discrimination

Rules to prevent tax discrimination are designed to encourage inbound foreign investment in a State and protect investment abroad. The non-discrimination rules in the UN and OECD Model Conventions apply to all taxes, including national and sub-national level taxes, income tax, VAT, property taxes, petroleum taxes etc.

Countries should review their domestic tax law to determine whether discrimination of the kind precluded by tax treaties exists. In conducting this review it should be noted that different treatment of residents and non-residents exists in most countries and is not prohibited, provided that there is no discrimination of a type that would breach the tax treaty non-discrimination rules.

If a domestic law would potentially breach the non-discrimination rules, and for good policy reasons (such as the prevention of tax avoidance or evasion) the country considers that the law must be maintained, the country Model should clearly specify the laws that are to be excluded from the operation of the treaty rules.

3.5 Mutual agreement procedure and arbitration

In accordance with usual tax treaty practice, a country's Model should provide an avenue for taxpayers to seek solutions to tax issues arising out the treaty, such as transfer pricing issues, through the mutual agreement procedure. Under this procedure, the taxpayer can request the Competent Authority of his country to try to resolve such problems, either alone or in consultation with the Competent Authority of the other country. The second sentence of paragraph 4 of UN Model

6 OECD *Tax Sparing: A Reconsideration,* 1997.

Convention Article 25 allows the competent authorities to develop 'appropriate bilateral procedures, conditions, methods and techniques' for the implementation of the mutual agreement procedures. Developing countries should consider the procedural issues discussed in Section C of the UN Commentary on Article 25, having regard, in particular, to the administrative capacity and resources of their tax administration and competent authorities.

The UN and OECD Model Conventions also includes an optional provision[7] that provides for binding arbitration procedures to resolve issues that the Competent Authorities are unable to resolve under the mutual agreement procedure. While the benefits of providing taxpayers with the certainty of arbitration procedures are beyond doubt, arbitration in the context of tax treaties is a relatively recent development and few tax treaties of developing countries currently include such an article. As noted in the UN Commentary on Article 25, countries with limited experience in the mutual agreement procedure could have difficulties in determining the consequences of adding arbitration[8]. Developing countries should consider whether their tax administrations have the legal and practical ability to support arbitration procedures and whether, as a matter of policy, they wish to do so.

3.6 Anti-abuse provisions

Some countries, particularly those with only a small tax treaty network, may be concerned that the reductions in source taxation offered through their treaties may expose them to abusive arrangements designed to obtain those benefits in unintended circumstances. They may also be concerned that residents of third countries with which they do not have a treaty may try to obtain the benefits of a treaty (treaty-shopping).

The Commentary on Article 1 of the UN Model Convention contains an extensive discussion of potentially abusive situations and suggests a number of possible solutions to combat such arrangements. In designing their Model, countries should consider whether to include any specific anti-abuse rules[9] or general anti-abuse rules[10] in their treaties.

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7 Paragraph 5 of UN Model Convention Article 25 (alternative B), OECD Model Convention Article 25(5).

8 Paragraph 3.

9 See paragraphs 31 – 33 of the Commentary on Article 1 of the UN Model Convention.

10 See paragraphs 34 – 37 of the Commentary on Article 1 of the UN Model Convention.

3.7 Administrative assistance

Exchange of Information

In accordance with modern tax treaty practice, and with a view to joining the worldwide push to stamp out harmful tax practices, the Model that any country develops should adopt the wide exchange of information provisions in accordance with Article 26 of the current UN and OECD Model Conventions.

These provisions authorise and require exchange of relevant information on all taxes, whether or not they are taxes covered by the treaty. The tax administration, if requested by the other tax administration, is required to collect and exchange all relevant information, even if that information is not required for its own purposes or is held by a financial institution. Countries should ensure that their tax administrations have the legal and administrative ability to obtain and exchange such information notwithstanding, for instance, domestic bank secrecy laws.

Paragraph 6 of Article 26 of the UN Model Convention provides that the competent authorities shall develop, through consultation, 'appropriate methods and techniques' concerning exchange of information. Countries should consider what procedures are appropriate for the competent authority of their country to provide effective exchange of information, including exchanges made on request, or automatically, or spontaneously.

Some developing countries may have concerns about the administrative burden placed on their revenue agencies by the obligation to exchange tax information. These countries may wish to include in their Model a provision requiring extraordinary costs incurred in providing information to be borne by the party requesting the information[11].

Assistance in Collection

While the current UN and OECD Model Conventions include an article (Article 27) which requires the tax administrations of both countries to provide assistance to each other in collecting taxes outstanding in the other country, it is recognised that not all countries will be in a position to accept such a provision[12].

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[11] See paragraphs 29.3 and 29.4 of the Commentary on Article 26 of the UN Model Convention.

[12] See footnote to Article 27 of the UN Model Convention.

Having regard, in particular, to the administrative burden this could place on the tax administration, developing countries may want to consider whether they are in a position to agree to such provisions.

3.8 Protocol

Some countries like to append a Protocol to their tax treaties, which sets out important interpretations and/or administrative provisions. Such Protocols are generally negotiated at the same time as the tax treaty and have the same legal status as the tax treaty.

Interpretive provisions are particularly useful where there might otherwise be doubt as to the intended operation or application of a tax treaty provision in one or both countries. This may occur, for example, where domestic law or jurisprudence in one country requires an interpretation that would not be followed in the other country. In this case, the two countries may agree during negotiations on a particular interpretation and set this out in the Protocol.

4 Conclusion

By developing a tax treaty policy framework, countries will be in a much better position to 'know what they want' out of treaty negotiations and to achieve outcomes that are in the best interests of the country. Such a framework will also assist countries in designing their country Model, which should reflect the policy outcomes sought.

Both the policy framework and the country Model should be reviewed regularly to ensure that future tax treaties continue to provide beneficial and appropriate outcomes for the country and remain up to date with international developments.